



# Memorandum

**TO:** PUBLIC SAFETY, FINANCE &  
STRATEGIC SUPPORT COMMITTEE

**FROM:** Julia H. Cooper

**SUBJECT:** SEE BELOW

**DATE:** May 6, 2015

Approved

Date

5-11-15

**SUBJECT: GASB STATEMENT NO. 68, ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS AND GASB STATEMENT NO. 71, PENSION TRANSITION FOR CONTRIBUTIONS MADE SUBSEQUENT TO THE MEASUREMENT DATE**

## **RECOMMENDATION**

Accept the report on the overview and implementation of Governmental Accounting Standards Board (GASB) Statement Nos. 68 and 71 for the City's financial statements for Fiscal Year 2014-2015.

## **OUTCOME**

To provide the Public Safety, Finance & Strategic Support Committee ("PSFSS") an overview of the fiscal impact and the implementation plan for GASB Statement No. 68, Accounting and Financial Reporting for Pensions and GASB Statement No. 71, Pension Transition for Contributions Made Subsequent to the Measurement Date ("New Pension Standards"). The New Pension Standards dramatically change the accounting reporting requirements with respect to defined benefit pension plans and the presentation in the City's financial statements. This memo provides an overview of certain financial statements in the City Comprehensive Annual Financial Report ("CAFR") that are affected by the New Pension Standards, particularly the government-wide financial statements, enterprise funds and agency funds financial statements for Fiscal Year 2014-2015.

## **BACKGROUND**

On June 25, 2012, the Government Accounting Standards Board ("GASB") approved GASB Statement Nos. 67 and 68, effectively replacing GASB Statement Nos. 25 and 27, respectively. These new standards were designed to improve and provide transparency to the accounting and financial reporting for state and local government defined benefit pension plans and to bring governmental employer accounting and reporting standards closer in line with private sector requirements.

The City implemented GASB Statement No. 67 in Fiscal Year 2013-2014. GASB Statement No. 68 (“GASB 68”) is effective for fiscal years starting after June 15, 2014. GASB Statement No. 71, an amendment to GASB 68, is required to be implemented simultaneously with the provisions of GASB 68.

In prior years, information on the pension liabilities was disclosed in the note disclosure and required supplementary information sections of the CAFR. With the implementation of GASB 68, the net pension liability will be reported on the face of the Statement of Net Position, effectively reducing an entity’s overall net position. Thus, GASB 68 changed the accounting and financial reporting requirements of pension obligations by reporting pension obligations not only on the note disclosure and required supplementary information sections but also on the face of the basic financial statements. GASB 68 affects the reporting and accounting presentation of the City’s pension liability; it is not a new liability and the City has been disclosing and profoundly aware of this liability.

Additional highlights of key changes include:

- Separating accounting for pension liabilities from the funding of pension liabilities
- Adding net pension liability (“NPL”) and deferred outflows/inflows of resources in the statement of net position. Deferred outflows/inflows are defined as the consumption or acquisition of net assets that is applicable to a future reporting period
- Eliminating the annual required contribution (“ARC”) concept for recognizing pension expense, however pension expenditures will still be used as the outflows measurement for governmental funds
- Pension expense will be a comprehensive measurement consisting of elements that have both immediate recognition (expenses “today”) and amortization of expenses with deferred recognition (expenses “in future”)
- Significant increase in note disclosures and information reported in the required supplementary information (“RSI”) in the CAFR

A comparison prepared by Macias, Gini & O’Connell (“MGO”), the City’s external auditors, between the previous accounting standard, GASB 27 and the New Pension Standards, GASB 68 and 71 is presented in Attachment A.

## **ANALYSIS**

The City contracted with MGO to review Finance staff’s calculations, perform additional guidance and provide training related to the City’s implementation of the New Pension Standards. This section of the report provides more discussion and analysis on the accounting changes associated with GASB 68/71 implementation.

### **Measurement Frequency and Valuation Requirements**

As mentioned, GASB Statement No. 68 is effective for financial statements for fiscal years beginning after June 15, 2014. Under GASB 68, there are two key dates – the measurement date and the actuarial valuation (“AV”) date. The net pension liability should be measured as of a date no earlier than the end of the employer’s prior fiscal year, consistently applied from period to period (measurement date). The net pension liability can be measured from an actuarial valuation as of the measurement date or

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roll forward amounts from an actuarial valuation as of a date no more than 30 months plus 1 day prior to the employer's most recent fiscal year-end. The actuarial valuation should be performed at least biennially.

The City will use June 30, 2014 as both the measurement date and the AV date for purposes of implementing GASB 68 for both the Federated Plan and the Police and Fire Plan. In future years, the calculation of the net pension liability and pension expense will always be one year behind the most current fiscal year. For example, actuarial valuations with measurement date as of June 30, 2014 will be used to report the net pension liability on the City's Fiscal Year 2014-2015 CAFR.

### **Impact on the Financial Statements**

Changes resulting from GASB 68 requirements apply only to the government-wide financial statements, enterprise funds (Airport, Wastewater, Municipal Water, and Parking Funds), and agency funds (Pension and SARA Trust Funds). GASB 68 does not apply to governmental funds; they will continue to report pension expenditures based on contributions made during the year. There is no change in cash flow, contribution rates or General Fund budgeted expenditures associated with implementation of GASB 68. In addition, the new measure used to recognize pension expense and pension liability eliminated the ARC concept for recognizing pension expense, resulting in the separation of accounting from funding.

For illustrative purposes, the Finance Department calculated certain line items in the financial statements affected by the New Pension Standards using the AV reports as of June 30, 2014 and the highlights of the impact to the government-wide financial statements including enterprise funds would have been on the June 30, 2014 CAFR.

	<b>Current Accounting Standards (GASB 27)</b> (in millions of \$)	<b>New Accounting Standards (GASB 68)</b> (in millions of \$)	<b>Impact of New Standards</b>
<b>Assets</b>	10,513	10,513	No change
<b>Deferred Outflow of Resources</b>	3	271	An increase of \$268 million (estimated pension contribution in FY 14/15)
<b>Liabilities</b>	3,751	5,449	An increase of \$1,698 million (net pension liabilities)
<b>Deferred inflow of Resources</b>	1	276	An increase of \$275 million (difference between projected and actual earning on investments)
<b>Net Position</b>	6,764	5,059	A net decrease of \$1,705 million to net position
<b>Expenses</b>	1,926	1,822	A decrease of \$104 million (\$268-\$164, contribution minus the pension expense)
<b>Adjustments to Restate Beginning Net Position</b>	6,961	5,151	A decrease of \$1,810 million to beginning net position

- The ***net position*** (total assets and deferred outflows of resources minus total liabilities and deferred inflows of resources) at June 30, 2014 for all reporting entities would have been \$5.06 billion, a \$1.705 billion decrease (25.2%) from the previously reported net position of \$6.764 billion (pre-GASB 68 implementation).
- ***Total long-term liabilities*** would have been \$5.449 billion as of June 30, 2014, an increase of \$1.698 billion or 45.3% compared to the previously reported \$3.751 billion long-term liabilities (pre-GASB 68 implementation).
- Under GASB 68, ***pension expense*** would have been \$163.6 million, a decrease of \$67.5 million or 29.2% compared to the annual pension cost of \$231.1 million under GASB 27 reported at June 30, 2014. The pension expense reported under GASB 27 was higher because it included the amortization of the unfunded actuarial accrued liability. Under GASB 68, the pension expense is measured as the difference between the net pension liabilities between two reporting periods.
- Of the total net difference between projected and actual investment earnings of \$344.5 million, \$275.6 million will be recognized as ***deferred inflows*** of resources. The budgeted pension contribution for fiscal 2014-2015 of \$267.9 will be recognized as ***deferred outflow*** of resources.

### **Restatement of Beginning Position and Allocation of Pension Expense Among City Funds**

#### **Methodology**

Implementation of the New Pension Standards is a change in accounting principle and will require recognition of a one-time prior period adjustment to restate the beginning net position. The total prior period adjustment on a government-wide basis is estimated to be \$1.705 billion (\$1.554 billion for governmental activities, \$144.8 million of business-type activities, and \$6.0 million for fiduciary funds).

The pension expense and prior period adjustment were distributed to different funds/activities by averaging the actual pension expense allocated to the funds over the last ten years. This methodology was chosen because it addresses the organizational changes the City experienced as a result of significant downsizing of the organization between FY 2008-09 and FY 2011-12. The percentages resulting from the allocation methodology are presented in Attachment B.

### **Rating Agencies and Capital Markets Concerns**

The credit rating agencies have prepared various commentaries on the implementation of GASB 68 and note that implementation will have a limited impact on municipal bond ratings given that the rating agencies' current internal credit analysis methodologies already account for pension obligations and liabilities. For example, Moody's indicated in its announcement on Global Credit Research dated June 30, 2014 (attached) that the "*new pension disclosures under GASB 67/68 will have limited impact on US state and local government ratings*". While no direct rating impact is anticipated, there will be impacts on financial ratios, bond covenant compliance, and other measures however, the Finance staff does not anticipate that these measures will negatively affect the reception of the City's credit in the capital markets.

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**Cost-Sharing Multiple-Employer (CalPERS) Plan**

The City's CalPERS Plan for the Mayor and members of the City Council will recognize their proportionate share of collective balances in the calculation of the net pension liability, pension expense and deferred outflows and inflows of resources.

For the CalPERS plan, accounting valuations for financial statements are expected to be available late in June 2015. CalPERS is anticipated to charge a minimal fee for the data, which it will make available through the on-line CalPERS System. There is currently no available data to estimate the net pension liability associated with this plan. However, given the minimal amount of the plan relative to the total assets of the City, the impact on the financial statements is expected to be limited.

**COORDINATION**

This memorandum has been coordinated with the City Manager's Office and City Attorney's Office.

/s/

JULIA H. COOPER

Director of Finance

For questions, please contact Grace O. Martinez, Deputy Director of Finance, at (408) 535-7034.

Attachments

Attachment A

# **Summary of Pension Standard Changes.**



# Summary of Pension Standard Changes.



	Current Accounting Standards (GASB 27)	New Accounting Standards (GASB 68)	Impact of New Standards
<b>Pension Liability</b> – recognized in plan sponsor's financial statements	<b>Net Pension Obligation (NPO)</b> – Measured as the cumulative difference between the employer's annual required contribution (ARC) and actual contributions	<b>Net Pension Liability (NPL)</b> – Measured as the difference between the employer's total pension liability (TPL) and the plan's fiduciary net position (PNP) as of the measurement date  $\text{NPL} = \text{TPL} - \text{PNP}$	<p>Inclusion of NPL on employer's statement of net position will result in major change in financial reporting ...</p> <p>It will substantially increase liabilities reported for most governments!</p> <p>The TPL will be more volatile than the current unfunded actuarial accrued liability (UAAL).</p>



# Summary of Pension Standard Changes.



	Current Accounting Standards (GASB 27)	New Accounting Standards (GASB 68)	Impact of New Standards
<b>Pension Expense</b> – recognized in plan sponsor's financial statements	<p><b>Annual Pension Cost (APC)</b> Measured as employer's ARC plus certain adjustments when an employer's actual payments are less than or in excess of the ARC.</p> <p>ARC = normal cost + amortization of UAAL</p>	<p><b>Pension Expense (PE)</b> – Measured as the change in NPL with certain exceptions.</p> <p><u>Immediate recognition:</u></p> <ul style="list-style-type: none"> <li>• Service costs (+)</li> <li>• Interest on TPL (+)</li> <li>• Changes in benefits (+or-)</li> <li>• Projected investment returns over the year (-)</li> <li>• Administrative expenses and other changes of the pension plan (+or-)</li> </ul> <p><u>Deferred recognition:</u></p> <ul style="list-style-type: none"> <li>• Changes in TPL due to changes in actuarial assumptions and differences in assumed and actual actuarial experience</li> <li>• Changes in PNP due to difference between projected and actual investment returns</li> </ul>	<p>New measurement will disconnect the relationship of funding to expense recognition.</p> <p>The direct relationship to the change in NPL with shorter deferral and recognition periods will increase the volatility in the new pension expense.</p> <p><b>Note: Governmental funds continue to report pension expenditures based on contributions made during the year.</b></p>



# Summary of Pension Standard Changes.



	Current Accounting Standards (GASB 27)	New Accounting Standards (GASB 68)	Impact of New Standards
<i>Deferred Outflows and Inflows of Resources</i>	Not recognized	<ul style="list-style-type: none"> <li>• <b>Changes in TPL</b> due to changes in actuarial assumptions and differences in assumed and actual actuarial experience.  These amounts are amortized over a closed period equal to the average of the expected remaining service period of all employees (active and inactive).</li> <li>• <b>Changes in PNP</b> due to difference between projected and actual investment returns. These amounts are amortized over a closed five-year period.</li> </ul>	Deferrals will provide some degree of "smoothing" of market volatility and changes in economic or demographic factors.



# Summary of Pension Standard Changes.



	Current Accounting Standards (GASB 27)	New Accounting Standards (GASB 68)	Impact of New Standards
<b>Discount Rate</b>	Long-term investment rate of return	<p><b>"Blended"</b> discount rate is used to the extent that projected benefits exceed projected plan net position.</p> <p><i>Long-term expected rate of return on assets and, if applicable, the 20-year AA/Aa tax-exempt municipal bond yield or index rate</i></p>	A blended discount rate could be lower than the long-term expected rate of return resulting in a larger TPL
<b>Attribution Methodology</b>	One of six allowed methodologies can be used	<b>Entry age</b> actuarial cost method	Use of one actuarial cost method will provide uniformity in the calculation of TPL and current service cost.
<b>Asset Valuation</b>	Generally smoothed market value	<b>Fair value</b> of plan's assets	Use of fair value will add volatility to the NPL and PE

## Attachment B

### **GASB 68 and 71 Implementation Percentages Used to Allocate Pension Expense, Prior Period Adjustment and Deferred Inflows/Outflows**

	<u>% allocation</u>
Airport	3.75%
Waste Water	6.41%
Water	0.47%
Parking	0.22%
ISF - Employee Benefits	0.09%
ISF - Public Works Program Support	1.23%
ISF - Stores, Vehicles, M&O	0.84%
Successor Agency (SARA)	0.09%
Retirement	0.45%
Governmental Funds (including General Fund)	86.45%
	<u>100%<sup>1</sup></u>

*a. The percentages were calculated based on the average pension contributions made in the last 10 years (FY04/05 through FY13/14)*



## MOODY'S INVESTORS SERVICE

### **Announcement: Moody's: New pension disclosures under GASB 67/68 will have limited impact on US state and local government ratings**

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Global Credit Research - 30 Jun 2014

New York, June 30, 2014 -- The new state and local government pension accounting standards, Government Accounting Standards Board (GASB) 67 and 68, scheduled to start later this year, will not change the methodology that Moody's Investors Service uses to adjust US state and local government pension data in its rating process. Some liability measures could be affected, however, by new information in the additional disclosure that the standards will require, specifically on the sensitivity of liabilities to changes in the discount rate.

Moody's explains the impact of the GASB 67/68 reporting changes on its credit analysis in the report, "Moody's US Public Pension Analysis Mostly Unchanged By New GASB 67/68 Standards."

"The revised standards do not change our approach to calculating Moody's Adjusted Net Pension Liability, or ANPL, for state and local governments, the measure of these liabilities that we use in our ratings," says Analyst Tom Aaron. "The new information that will be disclosed on the sensitivity of discount rates, however, could materially impact the results of our adjustments in some cases."

The additional disclosure is unlikely to impact ratings in the vast majority of cases, says Moody's. When it does, the information could be credit positive or credit negative, depending on pension plan liability characteristics.

Moody's will use the new liability disclosure related to discount rate changes for estimating the specific duration of a given plan. Absent other data, Moody's had previously assumed a uniform plan duration of 13 years in making its discount rate adjustments to plan liabilities.

Moody's will continue to adjust reported liabilities in their entirety using a high-grade corporate bond index tied to the actuarial valuation date.

Important changes in GASB 67/68 that will not change Moody's pension adjustments include the disclosure of local governments' shares of a multi-employee cost-sharing plans, and the appearance of net pension liabilities on local government balance sheets.

The accounting standards will change with pension plan disclosures for fiscal year 2014 and bond issuer disclosures for fiscal year 2015.

For more information, Moody's research subscribers can access the report at

[http://www.moody.com/viewresearchdoc.aspx?docid=PBM\\_PBM171874](http://www.moody.com/viewresearchdoc.aspx?docid=PBM_PBM171874).

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